

Report
The Division of Financial Assistance Did Not Adequately Discharge Its
Long-Term Stewardship Responsibilities For The California Rural
Development Demonstration Program
July 1, 2006 Through June 30, 2007
A-062

Executive Summary

Scope

The audit scope was the California Rural Development Demonstration Program (CRDDP) receivables outstanding as of May 30, 2007, and activity occurring (i.e. collections and write-offs) within those CRDDP receivables from July 1, 2006, through June 30, 2007.

Objectives

Our objectives were to determine if there were adequate internal controls to ensure that Housing and Community Development (Department) performs the following for the CRDDP receivables:

- Assign and define roles and responsibilities to monitor the receivables;
- Maintain adequate documents and records;
- Collect from borrowers when payments are due; and
- Write off loan balances from the accounting records when they are no longer collectible.

Summary

Division of Financial Assistance (DFA) has not adequately assigned and defined responsibility for monitoring the CRDDP. As a result, we noted that DFA did not have or perform the following for the CRDDP receivables:

- Have written policies and procedures for monitoring the receivables;
- Adequately maintain deeds of trust, promissory notes and street addresses for properties used as collateral;
- Initiate the process to bill the borrower when receivables become due;
- Review the receivables to determine if any are no longer collectible and initiate the process to write off any uncollectible receivables; and
- Have the agreement describing what the Department can do with the funds it collects from the CRDDP receivables.

High-Level Causes

The high-level causes are:

- DFA did not adequately assign and define responsibility to monitor CRDDP receivables.

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- The CRDDP received less attention after the Department loaned the monies received from HUD because it was a small one-time program. For example, no process exists to bill borrowers when their receivables became due; and
- DFA does not have written policies and procedures describing its responsibilities for monitoring the CRDDP receivables. DFA was unaware that they were not adequately monitoring the CRDDP receivables (i.e. maintain documents and applicable information, initiate the process to bill borrower, etc.)

High-Level Effects

The high-level effects are:

- Confusion exists among the DFA sections as to who is responsible for monitoring the CRDDP receivables and what functions DFA must perform to monitor these receivables. If roles and responsibilities are not properly assigned and defined, CRDDP cannot be operated effectively and efficiently.
- The Department may not be able collect up to \$101,899 in CRDDP receivables¹;
- The Department's financial statements may be overstated up to \$101,899 in CRDDP receivables¹; and
- The Department may have missed several opportunities for rural housing rehabilitation because it has accumulated \$57,871 from collections, but did not take any actions with regard to those accumulated funds.²

¹ It is possible that the Department may be able to collect on the \$101,899 in CRDDP receivables. However, The Audit Division believes that this is unlikely to occur because of the age of the receivables and the Department lacks adequate information and documents needed for collection.

² The Department is uncertain as to what it should do with the \$57,871 funds accumulated from collections. The Department does not have the agreement with HUD describing what the Department can do with the CRDDP funds it collects. However, federal funds collected usually return to the applicable program and are not deposited into the general fund or return HUD.

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Opinion

Our opinion is limited to our review of the CRDDP receivables and does not include any other receivables the Department administers. Based on our review, we determined that internal controls are not adequate over the CRDDP receivables. The Department did not adequately assign and define roles and responsibility for monitoring the receivables. As a result, the Department did not perform the following for the CRDDP receivables:

- Maintain adequate documents and records;
- Collect from borrowers when payments are due; and
- Determine which loan balances are no longer collectible and write off any uncollectible loan balances from the accounting records.

Auditing Standards Compliance

We conducted our audit in accordance with the *International Standards for the Professional Practice of Internal Auditors* promulgated by the *Institute of Internal Auditors*. Those standards require that we plan the audit, examine and evaluate information, communicate the results and follow up on any corrective action management is responsible for. We believe our audit provides a reasonable basis for our opinion.

Organizational Context

DFA administers more than 20 programs and is composed of the following seven sections: Rental Housing Development, Asset Management and Compliance (AMC), State Enterprise and Economic Development, Community Development Block Grant (CDBG), Home and Homeownership, Homeless and Housing Assistance and Infill Incentives.

During our audit, we discussed who was responsible for monitoring the CRDDP with staff from both CDBG and AMC sections, two of the seven DFA sections. Staff from both sections stated they were not assigned responsibility to monitor the CRDDP. The CDBG section manages and awards the State Community Development Block Grants (SCDBG) to cities and counties, a program which Housing and Urban Development (HUD), a federal agency, initiated in 1981. The AMC section is responsible for monitoring the status of loans funded by state funds.

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Staff in Financial Management Office (FMO), Administration and Management Division (AMD), stated that their role for handling the CRDDP receivables was limited to providing bookkeeping services. Specifically, FMO performs the following functions for each CRDDP receivable:

- Records payments and maintains balances; and
- Provides borrowers and/or title companies the amount needed to remove the lien on properties upon request.

Staff in CDBG section told us that the Chief in the Rural Development Office, located in the Department's satellite offices, handled the CRDDP receivables. DFA staff stated that the Department eliminated its Rural Development Office in 1985.

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Issue - No. 1

Missing Documents and Inadequate Records

Observation:

Division of Financial Assistance (DFA) does not adequately maintain deeds of trust, promissory notes and street addresses for property used as collateral for the California Rural Development Demonstration Program (CRDDP) receivables.

Discussion:

We selected for testing all 21 CRDDP receivables (valued at \$101,899) identified in the accounting records as of May 30, 2007. We could not locate for these receivables the following documents and information:

- Deeds of Trust for any of the 21 receivables;
- Promissory Notes for 95% (20 of 21) of the receivables; and
- Street addresses for property used as collateral for 76% (16 of 21) of the receivables.

Missing Documents

During our search for the deeds of trust and promissory notes, we noted the following:

- Staff in the Community Development Block Grant (CDBG) section, Division of Financial Assistance (DFA), could not locate any of the deeds of trust and promissory notes related to the receivables. CDBG Section staff checked with staff from the Asset Management and Compliance Section (AMC), DFA, which can ask for copies of documents kept in DFA's secure file room. AMC staff stated that they did not have any of the documents;
- Staff in the Financial Management Office (FMO), Administration and Management Division (AMD), stated they do not maintain files for any of the CRDDP receivables. FMO keeps within two binders a record of each CRDDP receivable's balance and when receivable payments were received. We found within one of the binders a copy of a promissory note for 1 of the 21 CRDDP receivables; and

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- Because the contracts for the CRDDP receivables were signed in the late 1970's and early 1980's, the Contracts Office, AMD, does not have any CRDDP files. The Contracts Office stated that its retention policy is to retain contracts for a maximum of seven years. The seven year retention of records includes 3 years in house and 4 years at the State Records Center.

Inadequate Records

Community Affairs Program Information Management System (CAPIMS) contains information relevant to the CRDDP receivables. Staff from the AMC section printed for us a report identifying all the CRDDP receivables listed within CAPIMS. The CAPIMS report did not contain street addresses for property used as collateral for 76% (16 of 21) of the receivables. In this situation, either the CAPIMS report did not contain any information for the receivable (i.e. 6 receivables) or the receivable was identified within the report but the field titled "Project Address" did not contain a street address (i.e. 10 receivables).

Cause:

Staff in the CDBG section told us that the Chief in the Rural Development Office, located in the Department's satellite offices, handled the CRDDP receivables. DFA staff stated that the Department eliminated its Rural Development Office. However, DFA did not adequately assign and define the responsibility to monitor on a regular basis the CRDDP receivables.

We initially thought that the Department had assigned the responsibility for keeping track of the CRDDP's documents and records to the CDBG section, the section responsible for State Community Development Block Grants (SCDBG), because each CRDDP contract number contains the acronym CDBG (i.e. CDBG-028). In addition, the Department's financial statements and CAPIMS identify CDBG as the program name for the CRDDP.

Staff in the CDBG section stated that they were not assigned responsibility for monitoring the CRDDP for the following reasons:

- They do not monitor loans to individuals. They manage and award the SCDBG to cities and counties, a program which Housing and Urban Development (HUD), a federal agency, initiated in 1981;
- They do not have access to CAPIMS, which contains the information relevant to the CRDDP receivables and the properties used as collateral; and

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- The SCDBG program did not exist at the time when HUD created the CRDDP in the late 1970's.

We talked to staff in the AMC section about their responsibilities. The AMC section is responsible for monitoring the status of state loans. Staff stated that they were not assigned the responsibility of monitoring loans funded by federal funds, such as the CRDDP.

Effect:

The Department may not be able to collect on its overdue CRDDP receivables if they can not identify or maintain for each receivable: location of property used as collateral, deed of trust and promissory note. As explained more fully within Issue – No. 2, the CRDDP receivables (valued at \$101,899) were either overdue or their status could not be determined.

Criteria:

State Administrative Manual Section 8776.6 (Revised 03/02) states:

“Each department will develop collection procedures that assure prompt follow-up on receivables...”

Receivables' Best Practices

State of Vermont, Department of Finance and Management Memo BP-04 (Issued 09/06) states:

“Departments shall devise and implement techniques and procedures to properly account for, record, manage, and collect receivables. Departments must take appropriate and cost effective actions to aggressively collect accounts-receivable.”

Recommendation:

It may not be possible or economically feasible for the DFA to locate the missing documents and information for the CRDDP receivables. DFA's manual system for record retention and retrieval failed in this instance. Therefore, we encourage DFA to implement an imaging system to keep track of its documents. Such a system would save DFA time in locating documents and would better help DFA account for and maintain its documents, especially for programs that require long-time monitoring. AMC staff told us they have a program that requires up to 55 years of

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monitoring. Over time it becomes harder to maintain documents when there is turnover of personnel, elimination of sections, and creation of new sections. AMC staff mentioned that Codes and Standards has an imaging system and that DFA staff has discussed the possibility of implementing an imaging system for its documents.

Responsibility:

Chris Westlake, Deputy Director of DFA

Management's Response:

None Submitted

Management's Action Plan:

None Submitted

Target Date:

None Submitted

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Issue- No. 2

Inadequate Collecting and Monitoring

Observation:

Division of Financial Assistance (DFA) did not initiate collection of California Rural Development Demonstration Program (CRDDP) receivables when the borrowers did not provide required payments. DFA does not have written policies and procedures for monitoring its CRDDP receivables.

Discussion:

Nineteen percent (4 of 21) of the receivables were past due. We could not determine the status for the remaining receivables.

Background Information

Housing and Community Development (Department) loaned these CRDDP funds to individuals in the late 1970's and early 1980's for such rehabilitation activities as new roofs and new water lines. The Department places liens on the borrowers' houses until the borrowers pay off the receivables. Housing and Urban Development (HUD); a federal agency, provided the Department with the funding under Title I for this pilot program titled California Rural Development Demonstration Program.

Based on information maintained by the Financial Management Office (FMO), 81% (17 of 21) of the receivables are not required to be paid off until the borrower sells the house. The remaining 19% (4 of 21) outstanding receivables are for fixed terms, ranging from 25 years to less than one year. The table on the next page categorizes the 21 receivables according to whether the receivable is due when the house is sold or is due after a fixed period of time.

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Terms of 21 Outstanding CRDDP Receivables as of May 30, 2007					
Receivable Period	Interest Rate	Number Of Receivables	Percentage Based On Number Of Receivables	Principal Amount	Percentage Based On Principal Amounts
Deferred Until Sale of Property	0% or 3%	17	81%	\$ 60,209.62	59%
Fixed-Term ≠	0%, 1% or 3%	4	19%	41,689.87	41%
		21	100%	\$ 101,899.49	100%

≠ = The four fixed-terms receivables are for the following periods of time:

- One receivable for 25 Years;
- Two receivables for 20 Years; and
- One receivable for a period of less than one year.

Past Due Receivables

As mentioned previously, we found that 19% (4 of 21) of the receivables were past due. Each of the past due receivables was for a fixed term. For one of the receivables, the borrower defaulted on receivable in April 1981, more than 27 years ago.

Receivables That Can Not Be Determined

As mentioned previously, we could not determine the status for 81% (17 of 21) of the receivables. All of these receivables are not required to be paid off unless the borrower sells the property. The DFA staff could not tell us whether any of these receivables were past due, since they did not monitor ownership changes to the properties.

In response to a request from us, staff from the Asset Management and Compliance (AMC) section, DFA, searched on-line within DataQuick for the current owners of these 17 properties. We noted the following as a result of the DataQuick on-line search³:

³ DFA subscribes to DataQuick, an on-line database used to identify ownership of property. DataQuick provides up to three ways (i.e. owner's name, property address and parcel number) a user can search for property data within the database.

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- Three properties were identified in DataQuick. However, the DataQuick data was not sufficient to determine for each property whether the borrower sold the properties, even though the DataQuick data indicated that individuals other than the borrower own the properties. Therefore, we are unsure of the status of the receivables applicable to these properties.
- Fourteen properties were not identified in DataQuick. Street addresses were only available for 21% (3 of 14) of these properties. AMC staff performed the DataQuick search with the borrower's name (which may or not be the same as the current owner of the property) and available address information. DFA does not gather parcel numbers which staff could use to search the DataQuick database. As discussed more fully within Issue - No. 1, DFA does not adequately maintain receivable documents and records for the CRDDP receivables.

Financial Management Office's (FMO) Role

FMO staff stated that their role for handling the CRDDP receivables was limited to providing bookkeeping services. Specifically, FMO performs the following functions for each CRDDP receivable:

- Records payments and maintains balances, and
- Provides borrowers and/or title companies the loan balance needed to remove the lien on properties upon request.

Each of the 21 CRDDP receivable balances recorded in FMO's records agreed with Accounting Office's records.

FMO staff stated that it is not their responsibility to initiate either collection or write-off of receivables. FMO explained that the collection or a write-off process starts when DFA provides FMO with a request to either collect or write-off a receivable. FMO forwards the requests for write-offs of receivables to the Accounting Office.

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Cause:

DFA did not assign the responsibility to perform the following functions for monitoring the CRDDP receivables:

- Adequately determine when receivables become past due as a result of changes in ownership to the properties used as collateral;
- Initiate the process to bill the borrower when receivables become due; and
- Determine which receivables are no longer collectible and initiate the process to write off any uncollectible receivables from the accounting records.

The Department placed liens on the property used as collateral for the CRDDP receivables. The Department expected the title companies or the borrowers to pay off the receivables in exchange for removing the liens from the properties. However, this control did not always work since a portion of the CRDDP receivables are already past due. As explained in Issue - No. 1, DFA could not provide us the deeds of trust showing that liens were placed on the properties.

Effect:

CRDDP receivables may not be collectible because:

- Receivables have been overdue for a long-time;
- Status of receivables cannot be determined; or
- It may not be possible to collect in an economically feasible manner.

As a result, the Department's financial statements may be overstated.

Criteria:

State Administrative Manual Section 8776.6 (Revised 03/02) states:

"Each department will develop collection procedures that assure prompt follow-up on receivables..."

"If all reasonable collection procedures do not result in payment, departments may request discharge from accountability of uncollectible amounts due from private entities..."

Receivables' Best Practices

State of Vermont, Department of Finance and Management Memo BP-04 (Issued 09/06) states:

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"Departments shall devise and implement techniques and procedures to properly account for, record, manage, and collect receivables. Departments must take appropriate and cost effective actions to aggressively collect accounts receivable."

"Written procedures exist for all accounts receivable and collection activities. Procedures should address preparing bills, recording receivables in the detail accounts receivable records, collecting the accounts, recording payments, adjustments to receivables, and follow-up of delinquent accounts."

"Procedures ensure the billing and collection of all receivables is performed promptly as part of an effective cash management program; use measurable goals and standards to monitor collection performance."

"Active efforts must be made to collect on accounts that are past due; document actions taken to collect on delinquent accounts."

Recommendation:

DFA should perform an analysis of its CRDDP receivables to determine whether it is economically feasible to collect or write off. If feasible to collect, DFA should initiate the process to collect. If not, DFA should initiate the process to write off.

Responsibility:

Chris Westlake, Deputy Director of DFA

Management's Response:

None Submitted

Management's Action Plan:

None Submitted

Target Date:

None Submitted

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Issue - No. 3

Disposition of Funds Collected Is Uncertain

Observation:

The California Department of Housing and Community Development (Department) is uncertain as to what should it do with the California Rural Development Demonstration Program (CRDDP) receivables it has collected.

Discussion:

We could not locate the agreement whereby Housing and Urban Development (HUD), a federal agency, agreed to provide the Department with CRDDP funds to loan to individuals during the 1970's and 1980's for such rehabilitation activities as new roofs and new water lines. As a result, it is unclear what the Department can do with the funds it collects from borrowers.

We researched the CRDDP in the Department's library. None of the reading materials we viewed provided information on what the Department should do with the CRDDP funds it collects from borrowers:

The Department deposits the funds it collects from the CRDDP into the Special Deposit Fund (0942). The program's assets include \$57,871 Cash in State Treasury (As of June 30, 2007). According to the California State and Accounting Reporting System (CALSTARS) Procedure Manual, "the purpose of Special Deposit Fund is to provide a depository for money collected or received in trust for specific purposes when no other fund has been created for those funds."

Cause:

DFA could not locate the agreement it has with HUD regarding the CRDDP.

Effect:

The Department is uncertain about the disposition of the CRDDP funds. Therefore, the Department may have missed the opportunity to further assist rural housing rehabilitation.

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Criteria:

Government Code Section 13402 states:

"State agency heads are responsible for the establishment and maintenance of a system or systems of internal accounting and administrative control within their agencies. This responsibility includes documenting the system, communicating system requirements to employees, and assuring that the system is functioning as prescribed and is modified, as appropriate, for changes in conditions."

Recommendation:

The Department should determine what it can do with the funds collected from the CRDDP receivables.

Responsibility:

Chris Westlake, Deputy Director of DFA

Management's Response:

None Submitted

Management's Action Plan:

None Submitted

Target Date:

None Submitted

**DEPARTMENT OF HOUSING AND COMMUNITY DEVELOPMENT
OFFICE OF THE DIRECTOR**

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March 11, 2009

MEMORANDUM FOR:William M. Young, Chief
Audit Division**FROM:**Lynn L. Jacobs
Director

A handwritten signature in black ink, appearing to read "Lynn L. Jacobs".

SUBJECT:November 17, 2008 Report on the California Rural
Development Demonstration Program**RECEIVED**

MAR 13 2009

AUDITS DIVISION

The Department of Housing and Community Development Department (HCD) has reviewed the Division of Audit's November 17, 2008 Report on the California Rural Development Demonstration Program (CRDDP) and is pleased to provide its action plan for addressing the issues outlined in the report.

Background: As indicated in the Report, the CRDDP was a small, federally funded program that made rehabilitation loans to individual homeowners in the late 1970s and early 1980s. Loans were provided primarily on a deferred payment basis, that is, the loans became due upon sale of the property, or on a fixed term basis of up to 25 years. The federal Housing and Urban Development Agency (HUD) did not continue the program after its initial funding round, providing no funding for continuing program oversight obligations. In addition, the HCD program that administered the CRCCP, the Rural Development Assistance Program (RDAP) was suspended in the mid eighties, due to State General Fund reductions. HCD's two small RDAP offices were closed; staff as well as office files were moved to the Sacramento headquarters.

Please be assured that HCD is committed to effective administration and oversight of its housing programs including those (the majority) that require some form of long term oversight. Members of the existing management team for the Divisions of Financial Assistance and Administration as well as most current HCD employees were not employed by HCD in the late 1970s to mid 1980s. However, it is likely that the fore-mentioned funding limitations, program closures, and HCD's focus on the implementation of major federal and State local assistance programs during the 1980s, led to an atypical failure to establish adequate long-term loan oversight and document control for this small demonstration program. HCD considers this condition atypical because it established strong long-term monitoring and loan servicing and accounting processes for federal and State loan programs in the late 1980s and early 1990s and now routinely builds these processes as a part of its design of new programs, such as

those created by Proposition 46 and Proposition 1C. Nonetheless, HCD welcomes this report as a reminder of why monitoring and servicing processes are necessary, as well as the importance of designating and reserving funding for out years' oversight for programs requiring long-term performance or obligations.

Recommendation: It may not be possible or economically feasible for the Division of Financial Assistance (DFA) to locate the missing documents and information for the CRDDP receivables. DFA's manual system for record retention and retrieval failed in this instance. Therefore, we encourage DFA to implement an imaging system to keep track of its documents. Such a system would save DFA time in locating documents and would better help DFA account for and maintain its documents, especially for programs that require long-term monitoring. Asset Management (AMC) staff told us they have a program that requires up to 55 years of monitoring. Over time it becomes harder to maintain documents when there is turnover in personnel, elimination of sections and creation of new sections. AMC staff mentioned that the Division of Codes and Standards has an imaging system and that DFA staff has discussed the possibility of implementing an imaging system for its documents.

Response: In addition to the DFA Secure File Room established for critical program documents, DFA has begun exploring the use of an imaging system to better safeguard and ensure retention of critical documents and facilitate access to them. A cross-divisional imaging pilot project team began work in February 2009. This effort is expected to identify the documents which should be imaged, by program, and determine the costs, benefits, feasibility and timelines for doing so. The team is expected to develop its initial recommendations by June 30, 2009.

Recommendation: DFA should perform an analysis of its CRDDP receivables to determine whether it is economically feasible to collect or write off. If feasible to collect, DFA should initiate the process to collect. If not, DFA should initiate the process to write off.

Response: The DFA, Financial Management Office and Accounting Office Branch search for in-house files or documentation related to the CRDDP receivables has encountered no additional documentation. DFA will request documents from the State archives for the period during which the program was in operation. DFA will complete its analysis and initiate collection or write off procedures, as appropriate, for each receivable no later than August 30, 2009.

Recommendation: The Department should determine what it can do with the funds collected from the CRDDP receivables.

Response: By May 30, 2009 the Department will discuss its recommendation for use of the remaining \$58,871 in collections from the CRDDP with HUD, since the program is no longer in existence. One option might be requesting HUD approval to use the funds

as program income for the Community Development Block Grant Program, which could be viewed as the replacement program since it has funded homeowner rehabilitation activities since its inception. HCD will request written confirmation of HUD's response.

I regret that this response has been delayed due to the involvement of key staff in addressing severe disruptions caused by the State's late budget. This report covers our actions through the end of February 2009. HCD will complete the 6-month status report on or before May 18, 2009.